4.03 Embedded Derivatives

Some instruments are not derivatives but include features that have the characteristics of a derivative. An investment in bonds has two inherent risks.

- There is **credit risk** because the issuer of bonds may or may not perform, which will affect the interest rate.
- There is **market risk** because the bonds will bear interest at a fixed rate and market interest rates may change, making the bonds more or less desirable and causing increases or decreases in their fair values.

Convertible bonds have an added feature in that they can be converted into common stock. As a result, increases in the stock price mitigate market risk as the bondholders can convert their bonds into shares of stock if the value of the stock exceeds that of the bonds. As a result, the value of the bonds will fluctuate as interest rates fluctuate and as the value of the stock fluctuates.

- The convertible bond would be considered a compound or **hybrid** instrument.
- The bond is the **host instrument.**
- The conversion feature would be considered an **embedded derivative.**

Since all derivatives are required to be reported at fair value, the entity will account for a hybrid instrument in one of two manners:

- If the host instrument is reported at fair value, the derivative is also reported at fair value.
- If the host instrument is not reported at fair value, the derivative will be separated or **bifurcated** from the host instrument and accounted for separately.
    - This would only be appropriate if the features have the characteristics of a derivative.
    - The derivative should have characteristics that respond to market influences differently from the host instrument

An example of an embedded derivative that can be separated from its host is a detachable stock purchase warrant that was acquired with an investment in bonds to be held to maturity. An example of an embedded derivative that **cannot** be separated from its host is the convertibility provision obtained with an investment in convertible bonds.

ASC 815 was issued to improve the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, it allows financial instruments that have embedded derivatives to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis.

Qualitative **disclosures** are required, regarding:

- How and why an entity uses derivative instruments
- How derivative instruments and related hedge items are accounted for
- How derivative instruments and related hedge items affect an entity's financial position, financial performance, and cash flows

- **Additional Disclosures**
  - Objectives for holding or issuing such instruments, and strategies for achieving those objectives
  - Context to understand the instrument
  - Risk management policies
  - A list of hedged instruments
  - Disclosure of fair value of financial instruments required when practicable to estimate fair value

Transfer & Servicing of Financial Assets

Entities, particularly financial institutions, will often dispose of financial instruments by transferring them to another entity. In many cases, these instruments are relatively favorable investments and the transferring entity may desire the ability to reacquire it. In other cases, the instrument may entail certain risks and the acquiring entity may desire the ability to dispose of it.

- A transfer of financial assets in which the transferor retains either the right or the obligation to reacquire the instrument, prior to its maturity, for an amount determined at the transfer date, is accounted for as a financing transaction, rather than a sale.
- In order to recognize the transfer as a sale, allowing the transferor to derecognize the instrument and recognize a gain or loss on disposal, three conditions must be satisfied:
  - The asset must be beyond the reach of the transferor and its creditors.
  - The transferor cannot place any restrictions on what the transferee can do with the asset.
  - There is no repurchase or redemption agreement that might allow the transferor to force a return of the asset.

Fair Value Option for Reporting Financial Assets & Financial Liabilities

ASC 820 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (at exit price)." An orderly transaction is a transaction that allows for normal marketing activities that are usual and customary, so they are NOT a forced transaction or sale.

Fair value measurements are required in certain circumstances:

- Derivatives are always reported at fair value.
- Identifiable assets acquired and liabilities assumed in a business combination are originally measured at fair value.
- Investments in marketable securities that are classified as either trading or available for sale.
- Most investments in equity securities.
- Impaired assets are written down due to their fair values.
- Nonmonetary transactions are measured at the fair value of the consideration exchanged.

In addition, there is a fair value option that allows an entity to elect to report virtually any or all of its financial assets and liabilities at fair value. When this irrevocable election is made, the item is remeasured at fair value on each balance sheet date and unrealized gains and losses are recognized in income.